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New Directions in the Financial Activities of the International Monetary Fund

Introduction

The International Monetary Fund conducts financial activities through what are called, since the Second Amendment of the Articles on April 1, 1978, the General Department and the Special Drawing Rights Department. The General Department consists of the General Resources Account, the Special Disbursement Account, and the Investment Account. No operations and transactions have been conducted so far through the second and third of these accounts. "Transactions" are defined by the Fund's Articles as exchanges of monetary assets for other monetary assets, and "operations" as other uses or receipts of monetary assets.

The main transaction conducted through the General Resources Account is the provision of financial resources to the governments of member states in balance of payments difficulties, in order to support economic programs designed to overcome those difficulties within the short or medium term without resorting to measures that would be destructive of national or international prosperity. The Fund must satisfy itself that a member's economic program is likely to be effective. The Fund is said to apply "conditionality" for this purpose.

Since the First Amendment of the Articles on July 28, 1969, the Fund has had the authority to allocate special drawing rights (SDRs) through the Special Drawing Rights Department (formerly the Special Drawing Account) to members participating in this Department, and operations and transactions involving SDRs are conducted through the Department. The SDR is a monetary asset that participating members may use, in accordance with the Articles, at will and without reference to the Fund's policies on conditionality. The SDR was defined originally in terms of gold, but is now defined in terms

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of a "basket" of specified amounts of 16 currencies. The exchange rate of a member's currency in terms of the SDR is determined by reference to rates of exchange in the market for the member's currency and the currencies in the basket.

The abandonment of the par value system established by the original Articles might have meant that members would have less need for monetary reserves than under that system. It is difficult to make a comparison of this kind, but it is clear that most members continue to feel the need to have substantial reserves. The overwhelming majority of members peg their currencies to a particular currency, or to the SDR, or to a composite of currencies of their choice. These members continue to hold reserves to meet possible imbalances in their external accounts. Members that have floating currencies may have a less obvious need for the financing of future deficits, but they use reserves, sometimes in considerable amounts, to intervene in the exchange markets to affect the rates of exchange for their own currency. Reserves are held, beyond the need for ordinary working balances, for other purposes. For example, a member may want to hold reserves because they may contribute to the maintenance of confidence in its currency and in its creditworthiness.

New developments have occurred in the recent past in connection with both the conditional use of the Fund's resources and the SDR. The Fund has a history of flexible response to constant change in the international economic environment. Some of the recent innovations in the Fund's financial activities are the subject of this paper.

Use of the Fund's Resources

Diversification of Policies

The original concept of the Fund's financial activities did not distinguish among the kinds of balance of payments problems for which the Fund would make its resources available, except that the resources were not to be used to finance large or sustained outflows of capital. All aspects of the Fund's law and practice on the use that could be made of its resources were based on a single Platonic idea of a balance of payments problem.

A member's subscription was equal to its quota, of which ideally one-quarter was paid in gold and the balance in its own currency. Subscriptions provided the Fund with a pool of resources on which a member could draw by purchasing the currencies of others. A member, when purchasing what was for it foreign exchange, paid an equivalent amount in its own currency. A member could make net purchases up to 25 percent of its quota in any period of twelve months, and could increase the Fund's holdings of its currency to 200 percent of quota, which implied a limit of 125 percent for outstanding purchases, but the Fund could waive either or both of the limits of 25 percent and 200 percent. A single system of "repurchase" prevailed. That is to say, the legal provisions under which a member had to buy back its own currency from the Fund with gold or the currencies of other members and reduce the Fund's holdings to the norm of 75 percent of quota were the same for all purchases. The Articles also prescribed a single system of service charges for transactions and periodic charges on holdings of currency in excess of quota.

With so monomorphic a structure for the use of the Fund's resources, it is not surprising that the Fund had only one policy for this purpose, the tranche policy. That part of it called the "gold tranche policy" governed purchases that would not raise the Fund's holdings of a member's currency above the level of its quota. These purchases were considered to be the economic equivalent of a member's gold subscription and the net use that the Fund had made of the member's currency subscription. The rest of the policy, the "credit tranche policy," dealt with purchases that would increase the Fund's holdings of a member's currency in tranches of 25 percent each to 200 percent of quota. These purchases were not equated with a member's own subscription but were considered to be uses of other members' subscriptions, and were regarded, therefore, in economic terms as "credit."

In accordance with policy, requests for purchases in the gold tranche were not subject to conditionality and were not challenged, because of the economic view that was taken of them. Requests for purchases in the four credit tranches had to meet standards of conditionality, because they were held to involve credit. The standards were less rigorous if purchases would not increase the Fund's holdings of a member's currency beyond the "first credit tranche," that is, beyond 125 percent of quota, but more rigorous if holdings would be raised beyond that level. Requests for purchases in the "reserve tranche," as the gold tranche is called since the Second Amendment, are now unchallengeable by force of law and not policy. The credit tranche policy also is still in force and remains the basic policy, so that all other policies can be considered variations on it.

The tranche policy was adopted in early 1952. After minor experiments with transactions in exceptional circumstances, the Fund, in 1963, established its first policy of major importance to deal with a special balance of payments problem. This policy has been the bellwether for a growing flock of special policies. The first of these special policies made resources available for the compensatory financing of balance of payments difficulties caused by shortfalls in the export proceeds of members, and notably the producers of primary products, provided that the shortfalls were largely attributable to circumstances beyond the member's control. The policy overlapped the tranche policy, however, in the sense that the holdings of a member's currency obtained by the Fund as a result of transactions under the policy were regarded as part of the Fund's holdings for the purpose of applying the tranche policy. Even though the Fund was willing to allow a larger total use of the Fund's resources for this reason, a purchase under the policy on compensatory financing, by increasing the Fund's holdings of a member's currency, might eliminate the gold tranche and the first credit tranche. This result was disadvantageous to the member because it lost the opportunity to make purchases without conditionality in the gold tranche and with light conditionality in the first credit tranche.

In 1966, the Fund took a further step of crucial importance. It decided that in applying the credit tranche policy it would exclude holdings of a member's currency obtained under the policy on compensatory financing. Building on these and further developments in policy and on amendment of the Articles, the Fund has established or expanded a series of policies on the use of its resources that can be regarded as parallel rather than overlapping. The conditionality, repurchase terms, and charges under these policies often differ from those that apply under the credit tranche policy. A member may be able to make purchases under several policies, with the result that its total outstanding use of the Fund's resources can be a multiple of its quota. The needs of members for balance of payments assistance and the volume of the Fund's transactions have led it to borrow on a substantial scale. Furthermore, the Board of Governors has decided recently on the latest of a series of adjustments of quotas that will increase total subscriptions from approximately SDR 39 billion to approximately SDR 58.6 billion.[1]

The Fund's policies can be classified in various ways. The reserve tranche policy must be unconditional, while all other policies must be conditional. The rigor of the conditionality that is required, or the speed with which adjustment of the balance of payments is expected, varies among the latter policies. Some policies are permanent, others are or have been temporary. Transactions under some policies have been financed wholly with the Fund's ordinary resources or with ordinary resources and resources borrowed by the Fund, but some policies have required that transactions under them must be financed wholly with borrowed resources. Some policies have not been related to a particular kind of balance of payments difficulty, while others have been designed to take care of a specific kind of difficulty. Some policies take account of the fact that a specific kind of difficulty is largely beyond the member's control, but others do not involve any such consideration.

Agreement has been reached to establish a special policy, the supplementary financing (or *Witteveen*) facility (SFF), that involves a new departure in the Fund's practice. The SFF, which will be of limited duration, is described in the next section of this paper. The problem for which a member may have recourse to the policy must be one that requires financing beyond the amount available in the credit tranches. Therefore, the total amount of assistance that the Fund may make available under the policy is not necessarily limited by reference to quota. Some uses are defined in relation to quota, but in addition the policy permits uses of the Fund's resources to an extent wholly unrelated to quota. The policy is the first and so far the only one that permits uses of this latter kind, although some recent transactions have been in unprece-

[1]*See* IMF Press Release No.78/80, Attachment I (November 6, 1978). The exchange rates of currencies fluctuate in relation to the SDR. On December 1, 1978 the exchange rate of the United States dollar was $1.265895 per SDR. On this basis, total subscriptions will be increased from approximately $49.4 billion to approximately $74.2 billion.

dented amounts because of the agreement that has been reached to establish the new policy as soon as arrangements are completed for borrowing part of the resources needed for financing it. Quotas have been an element, in one way or another, in the definition of the use of the Fund's resources that may be made under all other policies because reference to quotas is a simple and direct way in which to ensure uniform treatment among members and to control the effect of the policies on the Fund's liquidity. The concept of liquidity is a measure of the Fund's capacity to meet requests, and for this purpose can be considered to be equivalent to its holdings of the currencies of members in a strong balance of payments and reserve position, which therefore can be used in its transactions with economic justification, and other assets that can be used for balance of payments financing.

Development of Stand-by Arrangements

The original Articles made express provision only for requests by members to make immediate purchases of the currencies of other members. In the decade of the 1950s it became clear that members would find it a useful precaution to have the assurance that if they should need to make a request, the Fund would comply with it and would not invoke its various powers to postpone a decision on the request, to impose conditions for complying with it, or to reject it. With such an assurance, members could pursue sound policies of adjustment in the knowledge that additional reserves were available if they should be needed. The Fund developed the stand-by arrangement as the legal instrument for giving this assurance. The instrument has become the main technique for making the Fund's resources available and for applying conditionality, and, as a by-product, for demonstrating to other potential lenders that a member is pursuing policies of adjustment that have been endorsed by international opinion in the form of decisions of the Fund. In recent years stand-by arrangements have been approved more frequently as a remedy for existing difficulties than as a precaution against potential difficulties, although precaution continues to be the motive in some instances.

A stand-by arrangement is a decision of the Fund by which it assures a member, after consultation with the Managing Director and staff, that it will be able to purchase a specified amount of resources during a specified period in accordance with the terms of the decision and without further review by the Fund. The terms prescribe installments and the dates at which they become available to the extent that the amount of the stand-by arrangement goes beyond the first credit tranche.

The terms also provide that if certain elements in the member's program set forth in its letter of intent are not being observed, the member will not be able to make further purchases unless it consults the Fund and reaches understandings on such changes in the program as may be desirable. These elements ("performance criteria") are numerical formulations of a few macroeconomic variables in the program, such as a ceiling on the expansion of credit by the Central Bank or the banking system or a schedule of the aggregate reduction of arrears in payments for current international transactions. Performance criteria, however, may include elements that cannot be formulated in numerical terms, such as the avoidance of restrictions on payments and transfers for current international transactions, but the observance of performance criteria, whether numerical or not, can always be ascertained objectively by the Fund and by the member. The objective character of performance criteria prevents the weakening of the assurance given to the member that would result from the Fund's reservation of a right to refuse use of the stand-by arrangement on the basis of subjective judgments of the Fund.

The Fund regards the stand-by arrangement and the letter of intent as parallel declarations that do not constitute an agreement in the legal sense between the Fund and the member. It follows that the member is not in violation of any international obligation under the Articles of Agreement or under the stand-by arrangement because it departs from any of the policies, whether or not the subject of performance criteria, that are included in its letter of intent.

The early policy on stand-by arrangements provided for approval of them for periods of six months, because it was thought dangerous for the Fund to make commitments for longer periods. The development of protective clauses, including performance criteria, disposed of this trepidation. In time, the normal period became one year. This period was thought to be the maximum for which a member could plan its policies with the necessary precision. Another reason for the choice of one year was the Fund's reluctance to give even a qualified assurance of the availability of resources for a longer period. If a member's problem required a longer period for the adjustment of its balance of payments, there was danger of retrogression unless there were successive stand-by arrangements, and this practice did become common. Ultimately, there seemed to be no good reason why the period of stand-by arrangements should not exceed a year if it was clear in advance that a member's circumstances made adjustment over a longer period advisable, and that it was possible for the member to have a sufficiently firm framework of policy for the whole period. Within the framework, performance criteria could be established at the outset for the first year and in due time for subsequent periods.

It has been seen that stand-by arrangements for longer periods have been associated with problems requiring longer periods for adjustment than one year, and the further consideration of stand-by arrangements can be coupled with a discussion of developments in connection with adjustment.

Longer Periods for Adjustment

For many years, the Fund worked with the assumption that in many circumstances a program of one year in duration could achieve adjustment of the balance of payments and produce an increase in the member's monetary reserves that would enable it to reverse purchases from the Fund within three to five years after each purchase. In any event, the Fund felt that it could not safely approve stand-by arrangements for more than a year. Although it became increasingly clear that the assumption of the feasibility of adjustment within a year could be challenged, no change occurred until late 1974. The Fund's functions are confined to the balances of payments of members, and there was reluctance to accept programs and periods for repurchase of such duration that they might seem to go beyond the correction of the balance of payments. There was widespread concern that the Fund should not compromise, or appear to compromise, its distinctive function by engaging in activities that might be confused with development or other forms of long-term assistance. Moreover, although a program spread over a longer period might temper the rigor of conditionality and make adjustment easier, maintenance by a member of the discipline of a program for a longer period might be more difficult politically, and therefore be less likely to succeed.

Five chapters have been written so far in the history of the Fund's acknowledgment of the need for longer periods for adjustment and its willingness to undertake financial assistance in support of programs of longer duration:

I. EXTENDED FUND FACILITY (EFF)

In June 1974, the Committee of the Board of Governors on Reform of the International Monetary System and Related Issues (the Committee of Twenty) completed its work.[2] The Committee was established as a result of the breakdown of the par value system. Its terms of reference are sufficiently indicated by its name. One of the topics it considered was an increase in the transfer of real resources to developing members. The Committee was not able to reach agreement on more than the principle of the desirability of increasing this flow. It could not agree on specific measures, and in particular it could not agree on a "link" between development assistance and the allocation of SDRs, for which developing members had pressed tenaciously. Partly with the political objective of blunting the sharpness of disappointment felt by developing members, the Committee endorsed a new policy on the use of the Fund's resources that would be of particular benefit to these members. The Executive Board took a decision in September 1974 to establish the policy called the extended Fund facility. A slightly modified form of stand-by arrangement, called an extended arrangement, is the instrument that was created for the purpose of applying the policy.

The EFF is designed to deal with the balance of payments problems of members that are affected by structural maladjustments of the economy or conditions that are impeding growth, rather than, for example, seasonal or cyclical difficulties. The decision establishing the EFF describes the economies either as "suffering serious payments imbalance relating to structural maladjustments in production and trade and . . . prices and cost distortions

[2]INTERNATIONAL MONETARY FUND, INTERNATIONAL MONETARY REFORM: DOCUMENTS OF THE COMMITTEE OF TWENTY 3-232 (1974) (Hereinafter referred to as DOCUMENTS OF COMMITTEE OF TWENTY).

[that] have been widespread," or as "characterized by slow growth and an inherently weak balance of payments position which prevents pursuit of an active development policy." Extended arrangements have been approved so far (December 1, 1978) for Kenya, the Philippines, Mexico, Jamaica, Egypt, and Haiti.

The normal period of an extended arrangement is three years, and letters of intent are provided by the member before the arrangement is approved and at annual intervals thereafter. The amount of resources that the Fund makes available is larger than the amount available under the credit tranche policy. Repurchase is made within four to eight years, instead of three to five years, after a purchase.

II. Oil Facilities

On June 13, 1974 the Fund decided that it would make resources available for a limited period to assist members to meet the impact on their balances of payments of increases in the prices of imports of petroleum and petroleum products. These resources would be supplementary to any assistance that members might obtain under other policies of the Fund. The conditionality that members had to observe under the policy was mild because one purpose was to encourage members not to adjust too precipitately to the new situation by means of such undesirable measures as the imposition of restrictions on trade or payments. For this reason also the period for repurchase was three to seven years after purchases. The policy was financed with resources borrowed by the Fund. The amounts made available to members were determined in relation to their total balance of payments need, the increase in the cost of net imports of oil, quota, the volume of borrowing negotiated by the Fund, and certain other factors. On April 4, 1975 the Fund adopted a slightly modified decision in order to meet requests for assistance during a further period that were based on the impact of the increased costs of oil imports on the balance of payments during a period subsequent to the one to which the first decision applied.

III. Trust Fund

The Fund, as Trustee, administers a Trust Fund that it established by a decision of May 1976. This action also was inspired by the motive of assuaging the disappointment of developing members that has been mentioned in connection with the EFF. The resources of the Trust Fund are the proceeds, in excess of the former official price of gold, derived from the sale by auction of a portion of the Fund's gold, together with other resources lent or contributed by members. Sale of the gold is an action consistent with the objective of the Second Amendment of a gradual reduction in the role of gold in the international monetary system.

The purpose of the Trust Fund is to give balance of payment assistance, on concessionary terms, to augment the assistance available under other policies of the Fund, to certain members of the Fund that qualify during either or both of the periods of two years beginning on July 1, 1976 and July 1, 1978. For the first period, the members are the 61 whose populations had an average per capita income not in excess of SDR 300 in 1973, and for the second period the 59 members with an average per capita income of U.S. $520 in 1975. The figures need no comment.

Assistance is provided by means of loans and not sales of exchange. A condition of assistance is that a member has received a stand-by or extended arrangement or made a purchase in any of the credit tranches or is pursuing policies that would enable it to make a purchase in at least the first credit tranche. Notwithstanding the concessionary terms for assistance from the Trust Fund, a member must meet standards of conditionality, although they are not the most rigorous. Repayment begins not later than the sixth year and must be completed not later than the end of the tenth year after disbursement of a loan. This period is the longest one for which resources provided by the Fund on its own account or as Trustee may remain outstanding.

IV. Longer-term Stand-by Arrangements

Somewhat under the influence of the EFF, the Fund has begun to approve ordinary stand-by arrangements for longer periods, even though it has not yet abandoned the attitude that the normal period is one year. The new practice began with a stand-by arrangement approved for the United Kingdom in January 1977 for a period of two years. Since that date, stand-by arrangements have been approved for Italy, Jamaica, Peru, Turkey, and Zambia for periods varying from 20 to 27 months. The conclusion was reached in all cases, of course, that a program for more than a year was desirable. The period for repurchase in all cases, however, did not exceed the normal period of three to five years after purchase.

V. Supplementary Financing Facility (SFF)

In present conditions, some members face unusually serious balance of payments problems and require resources that are large in relation to their quotas. To limit these members to an amount of resources equal to the credit tranches or invariably by rigid reference to quota in some other way might contribute little to the solution of their problems. The Fund has decided, therefore, to establish the SFF for the benefit of members that need financing beyond whatever is available to them in the four credit tranches, require a relatively long period of adjustment, and a maximum period for repurchase longer than the basic three to five years. The SFF will be in existence for two years and possibly for three after it is activated. The Fund is making arrangements to borrow substantial amounts of currencies from certain industrialized and oil-exporting members. These borrowed resources will supplement the Fund's ordinary resources in the financing of purchases under stand-by or extended arrangements approved under the SFF.

The period of stand-by arrangements will normally exceed one year and may be as long as three years. The period of extended arrangements will be in accordance with the EFF. Repurchase in respect of that portion of purchases that is financed with the Fund's ordinary resources must be made within three to five years after purchase, and in respect of the portion financed with borrowed resources within three and one-half to seven years.

The five developments in connection with longer periods for adjustment show that the Fund has recognized this necessity by granting arrangements for longer periods than one year or by accepting longer periods for repurchase than three to five years or by both. Of the five developments, the extended Fund facility is the only permanent policy that has these characteristics.

Special Drawing Rights

Role of the SDR

In the decade of the 1960s the conclusion was reached that there was an inherent weakness in the international monetary system. A precise relationship between reserves and international transactions could not be postulated, but it was apparent that monetary authorities wanted their reserves to increase because the volume of international transactions tended to expand. Growing reserves give monetary authorities a sense of ease in pursuing policies and enables them to avoid policies that are detrimental to themselves or to other countries. Experience showed that little of the new production of gold was likely to be added to reserves because most of it was absorbed by the arts and industry and by purchasers whose motives were hoarding or speculation. The principal increase in reserves had taken the form of United States dollars generated by repeated deficits in the balance of payments of the United States. Reliance on these deficits for additions to reserves was considered undesirable for various reasons. These additions were not regulated by international decisions. Moreover, the fear arose that if official holders had to hold more United States dollars than they wanted to hold, their confidence in the currency would be undermined and a contagion of distrust would spread through the international monetary system.

International agreement was reached to resolve the predicament by the creation of a new reserve asset, the SDR, that could be allocated, under international decisions taken for successive "basic periods,"[3] to members of the Fund that decide to participate in the new venture ("participants").[4] The agreement was made effective by the First Amendment. Allocations are made to all participants at rates expressed as the same percentage of their quotas. The Fund was also empowered to withdraw ("cancel") SDRs that it had

[3]The standard basic period is five years, but it may be varied (art. XVIII, § 2(c)(i)). The first basic period was three years, the second, which began on January 1, 1973, was five years. No allocations were made in that period. The third basic period began as five years but has been reduced to four.

[4]On December 1, 1978, 130 of the 136 members of the Fund had become participants in the Special Drawing Rights Department, and of the rest, three had announced informally their intention to become participants.

allocated. If a cancellation were made, it would be expressed as the same percentage of the net cumulative allocations (allocations minus cancellations) that had been made to participants. The new asset was a bold effort to manage the international monetary system through the control of the total volume of unconditional international liquidity held by the monetary authorities of members of the Fund, but in order to reduce the dramatic effect in some participating countries for political reasons, the asset was given the dull name of the special drawing right (SDR).[5]

Decisions to allocate or cancel SDRs are taken by a high majority (85 percent) of the total voting power of participants. The purpose of so high a majority is to ensure that decisions of such novelty and importance are taken by almost the whole membership of the Fund.

Two obligations constitute the ultimate legal foundations on which the SDR rests. Upon request by a participant that wishes to transfer SDRs, the Fund must designate a transferee from among other participants. The designated transferee must accept the transfer and provide a currency deemed "freely usable" by the Fund. At the moment, the freely usable currencies are the French franc, German mark, Japanese yen, sterling, and the United States dollar, but the Fund may modify this list at any time. The transferee may decide which of these currencies it will provide, but it must provide value in terms of the exchange rate for the currency against the SDR that is the same whatever currency it provides. Neither the Fund nor the designated transferee may challenge an intended use of SDRs by a transferor, but a transferee cannot be compelled to accept SDRs to the extent that a transfer would increase its holdings of them beyond three times the net cumulative allocation of SDRs to it, although it can agree to hold more. The Fund may decide after a transfer has been made to a designated transferee that the transferor made it without a need to use reserves, that is, with the sole intention of disposing of SDRs for the purpose of changing the composition of the transferor's reserves. In these circumstances, the Fund may apply the remedy of designating the transferor to receive SDRs in order to reverse the effect of the transfer for the transferor.

The abundance of international liquidity in the form of reserve currencies in recent years frustrated the hope with which the SDR was created that it could be the instrument for controlling the volume of official international liquidity. Moreover, the growth of reserves in the form of currency produced the conviction that there was no case for the allocation of SDRs beyond the approximately 9.3 billion allocated in the first basic period, about which more is said later. The diminishing proportion of SDRs in total reserves exacerbated the sense of lost opportunity.

The Committee of Twenty was prevented by events from doing more than indicating the general direction in which the international monetary system

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[5] J. GOLD, SPECIAL DRAWING RIGHTS: THE ROLE OF LANGUAGE 3-11, IMF PAMPHLET NO. 15 (1971).

could evolve in the future. In its *Outline of Reform,* the Committee hoped that "[t]he SDR will become the principal reserve asset and the role of gold and of reserve currencies will be reduced."[6] The functions foreseen by the *Outline* for the SDR would be crucial in a new system, and would include among others those that follow. The SDR would be an asset with which members would maintain the official convertibility of their currencies. The SDR would be substituted for holdings of reserve currencies. It would be the common denominator of a revived but more flexible par value system.

The Second Amendment of the Articles, although a sweeping one that gave effect to many objectives, could not aim at creating the kind of international monetary system that was described in the *Outline of Reform.* For example, official convertibility is not restored, nor is a par value system. Nevertheless, one of the objectives as stated in the amended Articles is to make the SDR "the principal reserve asset in the international monetary system."[7] Just what this meant, or how the objective was to be achieved, or how a reconciliation was to be arranged between this language and the unchanged language of the First Amendment that refers to the SDR as a supplement to existing reserve assets, was not made clear, although it was understood that achievement of the objective did not require that the SDR should be the preponderant element in monetary reserves. These questions were not overlooked, but answers were left to the future. The new language, however, was an expression of dissatisfaction with the past and of hope for a more orderly future to which the SDR could make an essential contribution. The uncertainties of the language have provoked some skepticism, but it will be seen that the language has influenced some recent decisions of the Fund.

The decisions have been taken in order to begin to give some effect to the objective. They are discussed in connection with an increase in the volume of allocated SDRs, which has necessitated a closer look at the criterion for allocation in current conditions, and with improved characteristics of the SDR and more extensive uses that can be made of it. A guiding principle for the adoption of improvements is the delicate one of making the SDR attractive to hold but not so attractive that holders will be induced to hoard SDRs instead of using them in operations and transactions.

One difficulty in determining what improvements to make is that attitudes to the holding and use of SDRs may vary from time to time in relation to current conditions. For example, there is less disposition to part with them if exchange rates for the United States dollar are on the move, particularly downward. The Second Amendment has made the SDR potentially a more flexible instrument by conferring on the Fund new powers to improve its characteristics and extend its uses and by making it easier for the Fund to exercise powers of this kind that it had already as a result of the First Amendment. It would be paradoxical if the Fund were to be inhibited in the exercise

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[6]*Outline of Reform,* DOCUMENTS OF COMMITTEE OF TWENTY, *supra* note 2 § 24, at 15.
[7]Art. XXII.

of its new or broadened powers by differences of opinion about what would be improvements, but it will be seen that some movement has been possible.

Allocations of SDRs

The Articles establish a criterion for the allocation of SDRs:

> In all its decisions with respect to the allocation and cancellation of special drawing rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world.[8]

This provision was the subject of strenuous debate when it was incorporated in the First Amendment. Much of the debate revolved around the elements of a "supplement" and "long-term global need." A discussion of the provision published soon after the First Amendment became effective showed that no fewer than four ideas were compressed into the words "a supplement to existing reserve assets"[9] or "to supplement existing reserve assets."[10] These ideas can be summarized as follows:

(a) To state that SDRs are a supplement to existing reserve assets is not necessarily equivalent to the statement that SDRs themselves are reserve assets.

(b) SDRs have the characteristics that enable them to function as a supplement to existing reserve assets in the sense that they can be used as a form of international liquidity.

(c) SDRs are a supplement to existing reserve assets because they can make up for any deficiency in the global stock of existing reserve assets.

(d) SDRs are a supplement to, as distinguished from a substitute for, existing reserve assets. It was not intended that other reserve assets should cease to function as such because of the creation of SDRs, but if an asset did lose its quality as a reserve asset, or if its volume was reduced, SDRs could fill the gap. The provisions relating to the SDR, however, assumed the continued existence of currencies as reserve assets, because SDRs could not be used directly to make international payments, except to the Fund. SDRs would have to be transferred in exchange for currency with which payments could be made. The provisions also assumed the continued existence of gold as a reserve asset, because the SDR was defined in terms of gold.

All four ideas were part of a compromise by which the negotiators and drafters of the First Amendment delivered themselves from a vortex of contending ideologies about the task in which they were engaged. The first of the four ideas is the most obvious aspect of the compromise. Although almost everyone held the view that the SDR was to be a reserve asset, a few who

[8] Art. XVIII, § 1(a).
[9] Art. XV, § 1.
[10] J. GOLD, *supra* note 5, at 11-25.

preferred to regard it, for domestic political reasons, as a form of credit were enabled to give publicity to that analysis.

When the SDR was created, much attention was focused on the third idea. It was assumed that SDRs would be allocated in order to augment an inelastic supply of reserves and to prevent the deficiency that would exist in the absence of allocations. The supply of reserves would be inelastic because, as has been recalled, new gold would not be added to reserves in any substantial amounts and further accruals of dollars would be reduced by an expected better performance of the balance of payments of the United States. The Managing Director's proposal for allocations for the first basic period of 1970 through 1972 made a case for allocations largely on the basis of the current inadequacy of reserves and of the desire to sustain reserves, as evidenced by the prevalence of and increase in restrictions on international transactions and the increasing resort to arrangements for balance of payments financing, such as the spreading network of swap and similar arrangements among monetary authorities.[11] The Fund allocated approximately 9.3 billion SDRs, in roughly equal annual proportions, during the first basic period.

In recent years many countries have resorted to international capital markets for financing their balances of payments and for increasing their reserves. In these markets, resources have been plentiful, although they may cease to be available or may be difficult to obtain if a country's credit becomes questionable. The "off-shore" capital markets have become a dominating element in international monetary affairs because of their size and because of their freedom from national or international control. They not only escape control but also make it more difficult for international control to be exercised over the international monetary system. Some observers, peering through the telescope of hindsight, view the pioneers of Bretton Woods as having focused attention too intently on trade and as having neglected capital.

The necessary 85 percent majority of the total voting power of participants could not be mustered in support of a decision to make allocations of SDRs after the end of the first basic period. This result was not solely attributable to the view that the criterion of a global need was not satisfied. It might have been possible to allocate modest or symbolic amounts of SDRs during the second basic period in order to establish a practice of continuous allocation. Some members, however, would have objected to what they would have regarded as inadequate allocations. Other members that would not have resisted moderate or minor allocations because of size would nevertheless have resisted them on the ground that the tests of global need that were likely to be applied would have given inadequate recognition to the maldistribution of reserves and the needs of developing countries.

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[11] A Report to the Board of Governors of the International Monetary Fund Containing the Managing Director's Proposal on Allocation of Special Drawing Rights for the First Basic Period 6-7 (Washington, 1969).

The future of the SDR is affected not only by the total in existence but also by the proportion of total resources they represent as well as the pace and direction of changes in that proportion. The holdings of reserve currencies have increased much faster than was expected, so that the proportion of SDRs to total reserves exclusive of gold have declined from 10 percent at the end of the first basic period to about 4 percent and would probably decline further without new allocations.

The elastic supply of liquidity in private international capital markets and concern that the SDR might have to be added to the already long list of endangered species, so that the contribution it might make to the improvement of the international monetary system would wither, have been responsible for a new look at the criterion for allocation. It is agreed that to allocate SDRs without observing the criterion of a global need for a supplement to existing reserve assets would be wrong both legally and economically. The determination of the existence and the measurement of a global need of this kind have been the subject of much discussion and much disagreement, as can be seen from the published documents of the Committee of Twenty and its subordinate bodies. In current conditions the high level of reserves does not mean that a global need to supplement them is absent, because experience shows that members wish to increase their reserves as the volume of their international transactions rises. A continuing demand for reserves can be considered evidence of global need. There is, of course, no legal requirement that every member should experience a need for further reserves.

The criterion of global need does not mean that allocations of SDRs are the only way that can be found to meet the need. Reserves might be augmented by borrowing in international capital markets, but the propensity to resort to borrowing might be reduced by allocations of SDRs. A disadvantage of borrowing is that although gross reserves can be increased in this way, refinancing becomes necessary from time to time, and might give rise to difficulties. Allocations, therefore, may give members a greater sense of ease than they would derive from borrowing.

It has been recalled that one idea involved in the concept of a supplement to existing reserve assets was that if an existing reserve asset ceased to function as such, or if a decrease were to occur in total holdings of a reserve asset, SDRs could be substituted for the reserve asset in these circumstances and in this sense. A similar view could be taken if, because of allocations or some other development, total holdings of a reserve asset were to be less than they otherwise would be. This view was adopted by the Governors of the Central Banks of the seven active members of the Gold Pool in their *communiqué* of March 17, 1968, in which they announced the "two-tier" system of gold markets. Monetary authorities were to confine themselves to an official market and would refrain from purchasing gold in the nonofficial market. The *communiqué* stated that: ". . . as the existing stock of monetary gold is sufficient in view of the prospective establishment of the facility for Special Drawing Rights, they no longer feel it necessary to buy gold from the market." Furthermore, the special considerations applicable according to the Articles to the first decision to allocate SDRs, which included "the attainment of a better balance of payments equilibrium, as well as the likelihood of a better working of the adjustment process in the future,"[12] implied that there would not be an excessive expansion of the holdings of currency in the reserves of participants.

To give greater assurance that SDRs would be a substitute for currency in reserves in the sense that there would be less borrowing than would occur in the absence of further allocations, it has been proposed that a substitution account should be established and administered by the Fund. Participants would deposit in the account the equivalent in reserve currency of some portion or all of the SDRs that they would receive under new allocations. The proposal has not been adopted.[13]

The Interim Committee announced support for the "resumption" of allocations of SDRs and favored allocations of four billion SDRs in each of the three years 1979 to 1981. The Managing Director has made a proposal to the Board of Governors to "resume" allocations in these amounts, and the Board of Governors has decided in favor of them. The choice of the word "resume" is a faint suggestion that there might be a steadier practice of allocating SDRs in the future than in the past. Nevertheless, there is, and can be, no commitment for the future because decisions can be taken only in relation to prevailing and reasonably foreseeable conditions when the decisions are taken.

Improvements in the SDR

Numerous improvements have been made by the Second Amendment in the uses of the SDR or in its characteristics. Other improvements have been, or will be, made by decisions of the Fund. Only the more important improvements are discussed below.

Uses

I. TRANSFERS BY AGREEMENT

The provisions of the First Amendment established firm control by the Fund over transactions in SDRs in order to ensure that the Special Drawing Account would work efficiently and that the asset would not be weakened. One way in which this control was maintained was by the strict limitation of transfers of SDRs by agreement between participants, because this limitation reduced the risk of interference with the designation of transferees by the Fund according to its criteria. Consensual transactions, it was feared, might produce a maldistribution of SDRs and make it impossible to designate participants that were suitable for designation according to the Fund's criteria because, as a result of consensual transfers, they were already holding the

[12] Art. XVIII, § 1(b).

[13] *But see* Interim Committee's Communique, ¶ 5(d), September 24, 1978: "The Committee noted that the Executive Board intends to keep under review the question of a substitution account." 7 IMF SURVEY 308 (1978).

maximum amount of SDRs that they could be required to hold.

Early fears were dissipated, and increasing support for the idea of freedom to transfer SDRs by agreement culminated in a provision of the Second Amendment that authorizes these transactions subject only to remedies that are available to the Fund if a participant engages in transactions that are detrimental to the SDR system. Instead of the original assumption that broad authority to enter into consensual transactions would be harmful, it is now accepted that this authority enhances the quality of the SDR.

The change is associated with the removal of another clog on the transferability of SDRs. A participant was expected not to transfer SDRs to another participant designated by the Fund unless the transferor had an economic need to use reserves. The same rule applied to the limited class of transfers by agreement that was authorized by the Articles. In addition, the Fund could decide to permit transfers by transferors that did not have a need to use reserves in a few special and unusual circumstances. All of these provisions have been swept away, and any participant seeking to transfer SDRs may transfer them to a willing transferee without being subject to the expectation that it will engage in such transfers only if it has an economic need to use reserves.

II. New Operations

The Articles define "transactions" in SDRs as transfers of them in exchange for other monetary assets, and "operations" as other uses of SDRs. Before the Second Amendment, operations between participants were not authorized by the Articles. The Second Amendment enables the Fund to prescribe operations that participants may enter into by agreement between themselves on such terms and conditions as it may establish. The Fund will make a first exercise of this power by prescribing that SDRs may be transferred, between participants, to settle financial obligations, to provide security, and to make loans. Before the Second Amendment, participants could achieve comparable effects only by transferring SDRs for currency and using the currency to settle obligations, give security, or make loans.

III. Discharge of Obligations to Fund

The First Amendment did authorize participants to use SDRs in the direct discharge of obligations to the Fund, but this authority was narrow. The Fund was required to accept SDRs in the discharge of only two categories of obligation: reimbursement for the cost of conducting the business of the Special Drawing Account and repurchases of currency from the General Account that accrued in accordance with the formulae in the Articles. The Fund was empowered to accept SDRs in the discharge of only two other categories of obligation: other repurchases and the payment of periodic charges on currency held in the General Account as a result of outstanding use of the Fund's resources.

The limited uses that could be made of SDRs even in the discharge of obligations to the Fund were the result of the conservative attitude to the SDR of some negotiators. They wished to ensure that the SDR would not appear too much like a reserve asset and would not be too competitive with other reserve assets. They did not want it to be "as good as gold." This attitude is the one that has been referred to as the first idea incorporated in the words "to supplement" or "a supplement to" "existing reserve assets." Later, in the administration of the powers of the Fund relating to SDRs, attitudes changed, and those who had been conservative advocated an improved SDR, whereas some of those who originally had urged a more liberal approach did not want the SDR to become too competitive with the United States dollar as the main reserve currency.

On the occasion of the Second Amendment, there was no difficulty about extending the uses of the SDR in the discharge of obligations to the Fund because an objective of the Second Amendment was a gradual reduction in the role of gold in the international monetary system. One way in which this objective could be promoted was by the reduction of the role of gold in the Fund. Therefore all obligations of the Fund and members to pay or receive gold in the ordinary business of the Fund were eliminated. The SDR is the natural successor to gold in all the operations and transactions involving gold to which those members that are participants in the Special Drawing Rights Department had been parties in the past.

IV. OTHER HOLDERS

Although only participants can receive allocations of SDRs, other entities, in addition to the Fund itself, may hold them and engage in operations and transactions involving them if permitted by the Fund. Under the First Amendment, the Fund was authorized to permit countries that were not members of the Fund, or members that were not participants, or institutions that performed functions of a central bank for more than one member, to hold and use SDRs. The Fund was authorized to determine the operations and transactions involving SDRs that prescribed holders might enter into with participants.

The Second Amendment adds "other official entities" to the categories of possible holders. This new category is a broad one that would include both international and national entities. Moreover, the Fund may now authorize a prescribed holder to enter into operations and transactions with other prescribed holders and with the Fund as well as with participants.

Characteristics

I. METHOD OF VALUATION

The First Amendment defined the SDR in terms of gold, but when the United States withdrew its undertaking to convert foreign official holdings of United States dollars into gold and the par value system broke down it became unrealistic to assume that there existed an official price in United States dollars for gold that could be the medium for arriving at the exchange value of currencies in relation to the SDR. The Fund adopted instead the assumption that the gold value of the SDR was equal to a "basket" of determined amounts of the currencies of 16 members that had the largest shares in exports of goods and services during a certain period.

The Second Amendment contains no definition of the value of the SDR, and instead authorizes the Fund to establish and to change the method of valuing the SDR by decisions taken with high majorities of the total voting power. The SDR is the Fund's unit of account, as well as a monetary asset, and is being adopted increasingly by other international organizations and by public and private parties to financial transactions as their unit of account.

For all these reasons, it became apparent that certain considerations of policy should be observed in changing the method of valuation of the SDR. It was perceived that the method should be as stable as possible and therefore not changed often or for trivial reasons. The principles on which a basket was assembled should be applied consistently as the basis for changes. Predictability was desirable, which meant that these principles should be known in advance.

A decision has been adopted, with effect on July 1, 1978, that gives effect to these desiderata. The basket of 16 currencies was revised, and a formula established as a result of which changes may be made at intervals of five years unless the Fund decides on these occasions that changes shall not be made or shall be made according to principles other than those in the formula.

II. Rate of Interest

All holders of SDRs receive interest, paid in SDRs, on their holdings, and all participants pay charges, in SDRs, at the same rate as the rate of interest, on their net cumulative allocations of SDRs. It follows that participants holding more than their net cumulative allocations receive net payments that are financed by participants holding less than their net cumulative allocations. Other holders do not pay charges because they do not receive allocations, but they receive interest based on their holdings. These payments of interest also are financed by the participants holding less than their net cumulative allocations. Obviously, the rate of interest on the SDR is one of the characteristics on which its attractiveness depends.

There are relationships of law and policy among the rate of interest on the SDR, the remuneration that the Fund pays for what can be described somewhat imprecisely as the net use of a member's subscribed currency in the activities of the Fund conducted through the General Resources Account, and the periodic charges levied by the Fund on the holdings of currency acquired as the result of making its resources available to members through that account. The periodic charges are the main source of financing the payment of remuneration. Some of the tensions in the relationships referred to are: the desirability, because of the similarity between the rights attached to the SDR and the rights of a member in the General Resources Account, of having the same rate of interest on SDRs and on the net use of a members subscribed currency; the desirability of enhancing the attractiveness of the SDR by paying an adequate rate of interest; the undesirability of levying periodic charges at rates that are insufficient to finance remuneration, so that capital becomes impaired; and the undesirability of levying burdensome rates of periodic charge on members in difficulty. The word tensions has been used not only because the considerations that affect decisions on the various rates pull in different directions, but also because not all members give the same weight to each consideration.

Under the First Amendment, the rate of interest on the SDR was controlled by the rate of remuneration because it was provided that the rate of interest could be no higher than the rate of remuneration and the Fund decided that the rate should be the same for both. The rate of remuneration was fixed at 60 percent of the combined average of daily market rates of interest on certain obligations in the five main currencies in the SDR basket, weighted according to their shares in the basket. One, but only one, reason for the disparity represented by the proportion of 60 percent was that the rights attaching to a member's position in the General Resources Account on which remuneration is paid and the SDR are both maintained in value, whereas the market obligations denominated in the five currencies are not. Nevertheless, some holders of SDRs considered the rate of interest too low, particularly when compared with the rate of interest they could have earned by investing the currency they provided when other participants transferred SDRs to them. Some transferees might even have seen themselves as providing a subsidy to transferors in this sacrifice of interest.

The Second Amendment changes the relationship between the rate of interest and the rate of remuneration by making the former control the latter. The rate of remuneration may not be more than the rate of interest, but may be up to 20 percent below the rate of interest. After lengthy debate, it has been decided to increase the rate of interest on the SDR but without raising the rate of remuneration to the same level. The rate of interest will be 80 percent instead of 60 percent of the combined average of the market rates of interest payable on the obligations already referred to. The rate of remuneration will be 90 percent of the rate of interest, instead of being equal to it, which means that it will be 72 percent of the market rates of interest on the obligations. The rate of remuneration, however, may be raised from 90 percent toward or to equality with the rate of interest for any financial year of the Fund in which the estimated net income would be sufficient for this purpose, although it may be decided to lower the rates of periodic charge as the preferred course of action.

III. Reconstitution

The First Amendment and the Rules and Regulations required participants to maintain a minimum average daily balance of SDRs equivalent to 30 percent of their net cumulative allocations over successive periods of five years ending with each calendar quarter. Participants had to "reconstitute" their holdings if necessary to maintain the required average balance. The obligation of reconstitution was adopted as a compromise with those negotiators of the First Amendment who wanted to emphasize an element of credit in the SDR rather than its quality as a reserve asset. It is pertinent to refer once again to the first of the four ideas that were compressed into the language that refers to supplementing existing reserve assets. A practical rather than an ideological reason for reconstitution was that a better working of the SDR scheme might be ensured if some impediment were placed in the way of any participants that might be tempted to rid themselves systematically of all SDRs or were tempted to engross as many of them as they could.

The First Amendment authorized the Fund to modify or abrogate the rules for reconstitution, and the Second Amendment has made it easier for the Fund to exercise this authority. Over time there has been increasing pressure to abrogate reconstitution because those who hold this view consider that reconstitution detracts from the quality of the SDR as a reserve asset. They have argued that if the characteristics of the SDR were such as to make it a sufficiently attractive reserve asset, the objective of willingness to hold SDRs and to restore holdings of them after use would be achieved without the compulsion of obligation. The Fund has decided not to abrogate reconstitution altogether at this time but to reduce the minimum average daily balance from 30 percent to 15 percent of net cumulative allocation.

Effect of Changes

The negotiators of the First Amendment did not adopt a concept of the SDR and then deduce its uses and characteristics from that concept. Instead, they negotiated on particular uses and characteristics, although some negotiators at least based their advocacy in support of certain uses and characteristics on established legal and economic concepts.

Although it is obvious that the concept of the SDR can be understood only in relation to its own uses and characteristics, classification according to traditional categories is a challenge that lawyers and economists do not resist. For example, is the process of allocation a "credit" or a "grant"? Is the instrument itself "money," "credit," "legal tender," or a "reserve asset"? Does the receipt of SDRs in a transaction involve an "exchange of assets" or "credit" by the transferee?

In answering these and similar questions, the investigator must take into account all features of the SDR and the Special Drawing Rights Department, not all of which have been mentioned in this paper. One thing is clear: the extension of the uses of the SDR and the improvements in its characteristics have a profound effect on the answers to such questions as those that have been posed in the preceding paragraph.

Some Final Comments

This paper has dealt, with unavoidable brevity, with some recent new developments in the activities conducted by the Fund through the General Resources Account of its General Department and through its Special Drawing Rights Department. It is unnecessary, therefore, to attempt a summary, but it may be useful to emphasize a few of the points that should have emerged:

1. In a changing economic environment the Fund must have the legal powers to initiate and adapt policies on the use of its resources. The Fund has demonstrated that it has flexible powers by adopting a range of policies on the use of its resources, including some that deal with deep-rooted balance of payments problems, developing the practice of conditionality, and inventing first the stand-by arrangement and then the extended arrangement, and by constantly modifying and extending the policies and practices by which these activities are pursued and the instruments employed.
2. The Fund's policies are rigidly confined within the periphery of balance of payments assistance, but many forces can operate, on both political and economic levels, to induce the development of policy. The Trust Fund and the extended Fund facility are examples of the influence of these combined forces.
3. To be effective, the Fund must always have adequate resources with which to meet reasonably normal needs, but in addition the Fund must be reinforced by the willingness of members to lend to the Fund in order to enable it to meet abnormal needs. There are no accepted definitions of the adjectives normal and abnormal in this context.
4. The Fund needs adequate resources of both kinds to meet the needs of all members, whether developed or developing. In the determination of adequacy, however, the massive transactions recently entered into for the benefit of such developed members as the United States, the United Kingdom, and Italy deserve special notice.
5. The Second Amendment provides that the SDR is to become the principal reserve asset of the international monetary system, but does so in what some regard as less hospitable circumstances than in the days of the birth of the asset. Nevertheless, efforts are being made to maintain a vigorous SDR that will be able to undertake a more prominent and even a central role as international monetary arrangements are ordered and reordered in the future. New allocations, improved characteristics, and expanded uses all contribute to the vitality of the SDR. These developments also reflect combined political and economic aspirations for a better functioning of the international monetary system.